GLOBAL INSTITUTIONAL INVESTORS

Choices after October

With some exceptions, home is where assets stay

By Marlene Givant

While all global institutional investors pulled some assets home following the stock market crash, the Japanese are readying to send parcels abroad.

Japanese institutions still have massive amounts of capital to invest, and their trade surplus situation will mandate a return to foreign markets. Observers think the Japanese might take several courses:

- boost non-Japanese equity commitments to approximate last year's projected net of $17 billion;
- resume foreign bond purchases to the 1986 level of $93 billion, compared with the 1987 level of about $74 billion;
- increase direct foreign investment at a faster clip than securities purchases.

Meanwhile, European investors are catching their breath and staying put. The drop in equity prices in Europe probably will cause a drop in net inflow in the domestic equity markets and benefit the bond markets in 1988, according to a flow of funds report from Banque Paribas Capital Markets, London. Already, European investors are shifting domestic assets into bonds.

Foreigners are expected to sharply reduce equity investment in the Continent given its weak growth prospects. In addition, a 10% withholding tax on West German domestic bonds proposed for 1989 could adversely affect the flow of outside funds into that area. That money could be directed instead to Swiss or Dutch bonds.

U.S. investors — notably pension funds — however, are continuing to buy foreign securities and following through with plans to diversify overseas, according to Danielle Kadeyan, vice president of Salomon Brothers International Ltd., Tokyo.

But no global institutions are expected to match the Japanese in terms of range and growth of foreign investments in 1988.

Although stock markets crashed worldwide just as Japanese institutions were making their first sizable move into foreign equities, the Japanese are eyeing foreign stocks again, especially in the United States.

And with a steadier dollar, Japanese institutions are likely to resume purchases of foreign bonds, particularly U.S. government issues. (Foreign exchange and interest rate uncertainties sent Japanese investors' January net purchases of foreign bonds to their lowest point since March 1984, totaling $1.34 billion, down 33.3% from the previous month, according to the Ministry of Finance.)

Japan's $96.5 billion 1987 trade surplus will mandate Japanese foreign investment, especially in the United States.

"It's double-entry bookkeeping. . . . In practical terms, we need bilateral flows from Japan to the U.S. to solve both countries' trade imbalances," said Robert Brusca, chief economist and senior vice president of Nikko Securities Co. International Inc., New York.

Indeed, investment patterns that emerged in 1987 are unlikely to cease in 1988.

Japanese direct investment abroad increased each quarter in 1987, with nearly 30% of the outflows in the fourth quarter, said David Strongin, director of international finance of the Securities Industry Association, New York, and author of a report on Japanese investing.

John Calverley, senior economist of the American Express Bank, London, likened the vast scale of direct investment out of Japan to the U.S. expansion overseas in the 1960s. "The Japanese are becoming high-cost producers because of the high value of the yen," he said. "They want manufacturing operations in the U.S. and developing countries where there's cheap labor."

Japanese net purchases of foreign stocks in 1987 swelled to $17 billion from $7 billion the previous year, with about 65% to 70% in U.S. equities, the SIA report said.

In the first three quarters of 1987, the Japanese accounted for 40% of foreign net purchases of U.S. equities before declining in recent months, according to U.S. Treasury data.

The Japanese eventually might surpass U.S. investors in terms of gross equity activity away from home. In the first three quarters of 1987, Japanese foreign gross investment accounted for 30% of total foreign equity activity vs. 25% in 1986. The U.S. number posted a meager rise to 38.8% from 37.4% during the period, the SIA report said.

Foreigners, in turn, are reversing their strategies in Japan. After driving their representation down to 2.5% of the Tokyo stock market at the end of December from 4% before Oct. 19, foreign investors have

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World's markets, investors examined

Institutional investors have dominated the markets around the world throughout the 1980s. As U.S. institutions devoted an increasing portion of their assets to foreign investments, information on other markets and their investors has become vital to investing knowledgeably.

Now, investors are asking whether the 1987 crash spelled the end of global investing.

Have institutional investors retreated to their domestic markets for good? What are the implications for U.S. markets? What developments and trends are occurring around the world that affect institutional investment?

To explore these and other issues, *Pensions & Investment Age* presents a state-of-the-art look at institutional investing in nine countries: Japan, the United Kingdom, West Germany, Switzerland, France, Italy, Spain, the Netherlands and Australia.

These countries have the largest equity markets and the best-developed pension systems outside of North America.

What's going on in their markets and among their institutional investors has tremendous implications for U.S. investors — both in their own markets and abroad.

Explosive Japan looking overseas

By David Kilburn

TOKYO — Japanese institutional investors cut their teeth in the equity markets through "tokkin" accounts. Now, like toddlers learning to walk, they might have to relearn their lessons after the tumble they took last year.

Nevertheless, the growing role of Japanese institutions in global equity markets won't be reversed.

"There simply are not enough instruments available in Japan to absorb the money available. This is one of the main forces behind overseas investment by the institutions. This same pressure is also a reason why the (Tokyo Stock Exchange) can go up at such an incredible pace," said Anne Cabot, senior marketing manager at Sanyo Securities Co. Ltd., Tokyo.

Tokkin funds, which are vehicles for the investment of surplus corporate assets, led the change in institutional investors from cautious bond investors and long-term holders of corporate equities to more active equity players.

Top 5 institutional investors

($ billions as of March 31, 1987)

Sumitomo Trust (MB)	51.5
Nippon Life (IN)	49
Mitsubishi Trust (MB)	46.7
Mitsui Trust (MB)	38
Toyo Trust (MB)	31.5

Top 5 pension funds

Local Gov't Employees	65.5
Nat'l Gov't Employees	22.5
Employees Pension Fund	8
All Japan Mutual Credit Bank	2.1
Hitachi	1.3

Source: InterSec Research Corp., London

Boosted by burgeoning corporate surpluses, the tokkin and related fund trust accounts have surged in the past three years, to $229 billion in November 1987 from $21 billion in March 1985, according to Japan's Trust Bank Association.

Traditionally, corporations purchased strategic holdings in companies with which they did business, but did not trade them. But the tokkin money, held in separate funds, permitted companies to experiment with different investment strategies.

The result was a fantastic level of trading, including what some believe were speculative excesses. According to an analysis by Masanobu Takahashi, research director of Sanyo Securities, trading by tokkin and fund trusts accounted for about 15% of the total floating supply of equities in 1986, with portfolio turnover ratios up to 300%.

The importance of these funds to the $3 trillion Japanese stock market has become clear: threats of stock sales by the funds inspired the Ministry of Finance to take two crucial steps in January.

To prevent such sales, the ministry eased accounting requirements for tokkin and fund trust accounts, and permitted life insurance companies to boost their tokkin accounts to 5% of assets from 3%. It also postponed a rule change so losses on tokkin holdings could be diluted by unrealized capital gains in long-term securities holdings.

Since August, however, the flow of new money into tokkin funds has slowed, as more corporate cash has been poured into capital investment.

But if tokkin fund growth is slowing, Japanese pension funds are taking off. Both domestic and foreign firms are elbowing to break into the $190 billion corporate pension fund market. While only trust banks and insurance companies can manage the funds, brokers and national banks are seeking permission to provide investment advice to the market, which is expected to reach $255 billion by 1990.

Meanwhile, the Health and Welfare Ministry has proposed legislation allowing pension funds with more than $150 million (20 billion yen) in assets to manage up to one-third of assets internally.

The growth of all types of Japanese institutional investors has led to long-reaching changes in investment approaches.

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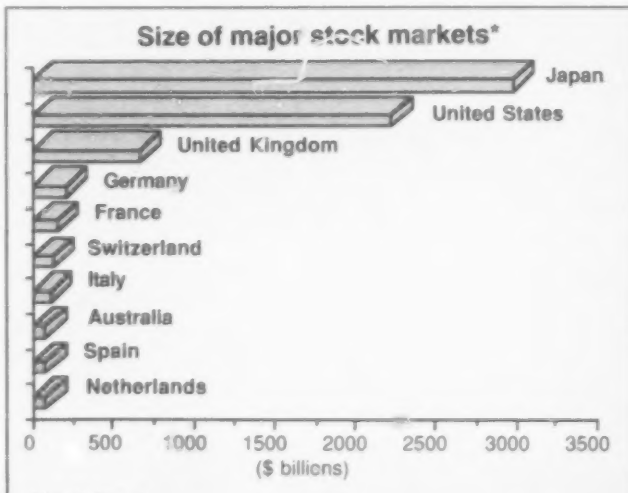
Valuation measures of world equity markets
(as of Feb. 12, 1988)

	Current p/e	Average p/e 1973-86	Current p/e as a % of average	Current earnings yield	Long-term gov't bond yield
Australia	10.2	11.3	90.1%	8.83%	12.60%
France	12.6	11.8	106.8	8.47	9.49
Germany	10.7	11.6	92.2	8.62	6.10
Italy	15.9	27.3	58.2	3.66	10.23
Japan	59	22.9	257.6	4.37	4.45
Netherlands	10	6.8	147.1	14.71	5.99
Spain	16.6	11.3	146.6	8.83	12.77
Switzerland	10	11.5	87	8.70	4.07
United Kingdom	13	10.5	123.8	9.52	9.42
United States	13.5	10.3	131.1	9.71	8.42

Source: Merrill Lynch Capital Markets, New York



*As of Jan. 1

Source: Morgan Stanley Capital International, New York.

British taking few chances

By John Westwell

LONDON — Despite the U.K. stock market's woeful performance in 1987, British institutional investors think the domestic market is the place to be in 1988.

While they have shifted assets to British stocks from foreign equity markets since October, they are playing the market very cautiously.

"The message is we seem to be on course for a soft landing but not for a collapse," said John Shelley, director of London-based MIM Britannia, which has $2.07 billion under management.

David Barker, director of merchant bank Hill Samuel Group Ltd., London, with about $24.4 billion under management, said both U.K. stocks and real estate are cheap at today's level but he is concerned the market is unlikely to make any rapid recovery in the next few months.

While he thinks the stock market will be higher next year, at the moment trading is "definitely sluggish and nervous."

"Flat" is the verdict of Donald Brydon, director of asset management at Barclays de Zoete Wedd, London. The strategy at BZW, which is the investment arm of Barclays Bank PLC and has $19 billion under management, is "defensive and well-diversified," Mr. Brydon said.

British pension funds, with an estimated $450 billion in assets, have kept up their strong commitment to stocks. The Wyatt Survey of Pooled Pension Funds shows British fund managers had 74% of assets in stocks at the end of 1987, down minimally from 75% at the beginning of the year.

The big change, according to Wyatt, was that U.K. equities increased to 58% of total assets from 53% while foreign equities dropped to 16% from 22%.

This commitment to British stocks comes despite the U.K.'s dismal performance since October. The Financial Times-Stock Exchange 100 index has fallen 386.9 or 17.6% since Oct. 15 to its March 11 closing of 1,810.4. This represents a recovery, however, of 249.9 points, or 16%, from its low Nov. 9 of 1,565.2.

Just as important is the falloff in trading volume. In the week before the crash the average number of shares traded per day was 594 million, with an average value of shares traded of $3.76 billion. By the week ended Feb. 26, these figures had slumped to 394.14 million and $1.95 billion respectively.

At the end of 1987, there were 2,061 domestic equities with a market capitalization of $635.7 billion traded on the International Stock Exchange (formerly the London Stock Exchange). There also were 126 securities traded on the gilts (government bond) market with a combined value of $249.7 billion.

In the U.K. equity market, life insurance and pension funds own about one-half of outstanding equities while unit trusts, general insurance companies and investment trusts account for a further 10%, according to Salomon Brothers Inc., London.

Unit trusts in particular have soared, growing more than 500% between 1981 and 1986, to $48.6 billion.

Given about 60% of all transactions are conducted between marketmakers, that suggests institutional investors are unwilling to commit themselves to the equity market, although the experts are not in accord.

Executives at Capital House Investment Management Ltd., a wholly owned subsidiary of the Royal Bank of Scotland Group PLC, which manages more than $3.6 billion, including $2.52 billion in pension assets, point out equities have provided long-term returns well above those in cash and bonds.

A typical asset allocation for a Capital House client as of this month was 63.5% in U.K. shares and convertible securities, 18.5% in overseas securities, 7.5% in fixed income and 10.5% in cash.

But some managers are looking more to bonds than they have in a long time.

"We advised clients to put 40% into gilts 18 months before the crash," said Piers Mount Stephens, a director with pension fund responsibility at C.S. Investments Ltd., London, which has $900 million under management.

"There appears to be a lot of cash now available in the pension funds but nobody knows what to do with it. If pension fund managers commit it to bonds, it would be an admission that they got it wrong to start with," he said.

Although investments by U.K. funds into real estate have been on the decline — a typical allocation in a major fund ranged between 5% and 10% in October, down from an average 21% in 1981 — perceptions might be changing.

"After the twin October hurricanes (an actual hurricane Oct. 16 followed the financial one Oct. 19), property is once again seen as a more stable form of investment," said Nick Ryan, secretary of the $360 million Superannuation Arrangements of the University of London. "Now that some of the glamor has gone out of equities, we should seriously be studying the property markets."

The fund's exposure to property has been limited to pooled investments, Mr. Ryan said. "But with the advent of unitized single property instruments (similar to real estate syndications) in the U.K. expected later this year, SAUL and other funds see new opportunities for direct property investment," he added. ■

Top 5 Institutional Investors

($ billions as of Dec. 31, 1986)

Prudential (IN)	34.6
Robert Fleming (MB)	29.6
Mercury Asset (MB)	26.4
Morgan Grenfell (MB)	21.3
Legal & General (IN)	16.7

Top 5 pension funds

British Coal	15.2
Electricity Council	11.1
British Telecommunications	5.4
Post Office	3.6
British Railways Board	3.4

Source: InterSec Research Corp., London

Key to investor types

CB: Commercial bank
MB: Merchant bank
IM: Independent mgr.
UT: Unit trust mgr.
IN: Insurer

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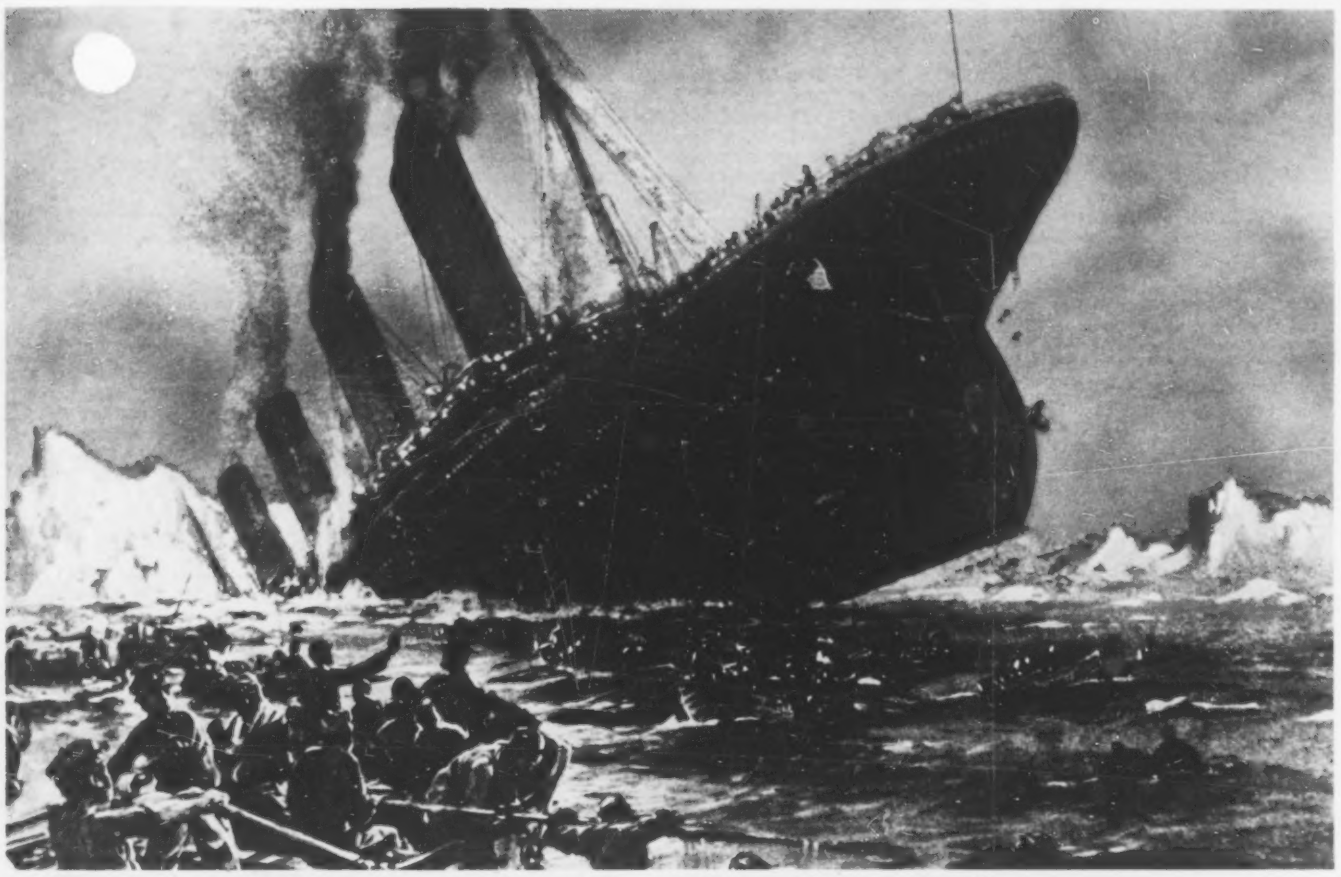

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Glimmer for equities

Germans take a gamble on stock market

By Peggy Trautman

BONN, West Germany — Contrary to many investors, West Germany's traditionally conservative institutional investors have increased their stock positions in the wake of Oct. 19.

While that might seem surprising, at first, it's not: German institutional investors — mostly life insurance companies and pension funds — now have invested 8% to 9% of assets in stocks, up from about 6% before October.

But any increase in stock holdings is welcomed by analysts — especially in light of the drubbing investors took on the German exchanges. West Germany was one of the worst-performing markets in 1987, dropping 33.4% from Oct. 15 to year end.

German investors, both institutions and individuals, remember the losses of the post-war years and are closely tied to bonds.

Now, although individuals still are holding back, institutional investors are finding stocks more attractive.

"Since stocks were basically cheap (after the crash), it reduced the attractiveness of competing investments," said Siegfried Hoecker, head of equity investment for Capital Management International GmbH of Deutsche Bank, Frankfurt, which manages $2 billion in discretionary assets for foreign and domestic clients.

West German investors made net stock purchases of $8.99 billion in 1987 — of which $8.73 billion were made in the last quarter. Most of those purchases probably were made by institutions, which owned 83% of all German stocks as of year-end 1986 (the latest data available). The remainder was held by individuals.

Institutional investors' willingness to take a bigger bet on stocks also might stem from a fundamental change in attitude.

"They are becoming conscious of the fact that it doesn't make any sense to jump in and jump out," said Ekkehard Scheid, a partner in Portfolio Management GmbH, Munich, which manages $190 million in assets.

Hans-Dieter Runte, managing director of BHF Trust Management MbH, Frankfurt, which manages $3.8 billion in discretionary assets for foreign and domestic clients, agreed. He noted institutional investors were not nearly as cautious after the crash as many observers had feared, reflecting their long-term commitment to the market.

West German institutions also are running counter to the traditional notion of "witschaftswunder" — that is, when the Germany currency is strong, export-reliant corporate profits are weaker. Thus, German investors typically flee to bonds when the deutsche mark is strong.

Fortunately for the West German market, this change in attitude revealed itself as foreign investors fled during the crash.

Foreign investors were net sellers of $1.5 billion in stock, and many — especially the British and Swiss — are slow in returning. And it's not clear when foreign investors will come back.

West Germany's planned 10% withholding tax on income and dividends might deter foreign investors. It already is driving up pricing, causing yields on domestic debt instruments to increase by 25 basis points in February, according to the Bundesbank, the country's central bank.

Foreign investors also fear the deutsche mark's increase against the dollar will harm German exports. If the exchange rate holds at the 1.70 level, economists figure German industry will get by; but further dollar depreciations would be bad news for the market, said Capital Management International's Mr. Hoecker.

But the most important investors are the banks, which were forced into the role of dedicated marketmaker or willing speculator — depending on opinion — immediately after October's panic. Banks, which have $1.8 trillion in capital, bought $320 million in shares. Later, when a downward trend was evident, they sold $570 million in stocks to cut their losses.

Now the banks would rather return to government bonds, where returns are high and risks low. However, it might be too soon. "Even if one bank were to sell (its stock holdings), the bourse could fall all over again," one major bank official said. "And the expected rebound has not been quick in coming." ■

Top 5 institutional investors

($ billions as of Dec. 31, 1986)

Allianz Group (IN)	24.5
Deutsche Bank (CB)	21.5
Dresdner Bank (CB)	18.5
Volksfursorge Lebensversicherung (IN)	6.3
Hamburg-Mannheimer Versicherung (IN)	5.9

Top 5 pension funds

Deutsche Bank und Bankiergerwerke	4
Bayerische Arzteversorgung	3
Beugewerbe ZVK	2.4
Bayer AG	2.2
Hoechst AG	1.9

Source: InterSec Research Corp., London

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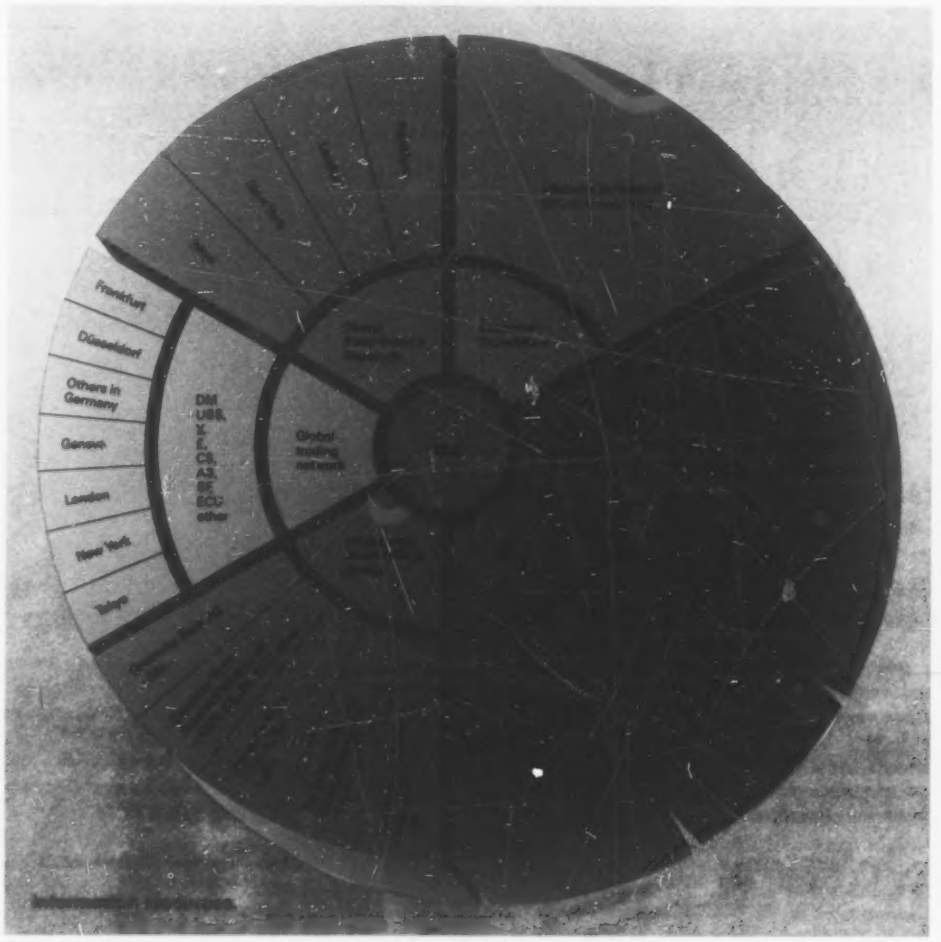

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Spanish growth wild

By Paul L. Montgomery

MADRID, Spain — In the Spanish equities market, the highs generally are higher than the world average, but the drops are just as precipitous.

After racking up gains of 322.8% from July 1982 until the October crash, the Madrid exchange lost about 24.4% of its value by Nov. 13, but by March had recovered about half the losses.

Gains have continued, and with analysts finding most economic indicators favorable in Spain for continued growth, the outlook is for another record year on the exchange.

But with only a fledgling pension fund industry to provide stability and the highest economic growth rate in Western Europe, playing the market in Spain is a game for experts.

Spain, which joined the European Community with Portugal at the beginning of 1986, is already benefiting from its new associations. Spain's growth rate in 1987 was 4.1%, compared with the European Community average of 2.2% and the United States' 2.3%.

The estimate for 1988 is 3.7% in Spain, according to the European Communities Statistical Office. Part of the reason is that Spain has had further to come, but Spain also is in the midst of an economic boom.

Big banks are still the major stockholders in Spain, but foreign buyers, investment funds and the young pension industry are all making inroads. It was estimated foreign buying on the major exchanges last year rose 80% after a similar rise in 1986, although the total foreign purchases are still less than $2 billion.

Easing restrictions on foreign investors in May 1985 has helped. Foreign investors tend to be British, German, Dutch or Belgian, but last year there was a considerable influx of money from the Middle East, particularly Kuwait.

Spain's Socialist government has encouraged private initiatives in many areas, including private and union pension funds. Although institutional investors probably account for less than 10% of the Spanish market, the number is growing, said Jaime Montoya, president of Seguros Madrilenos, a Madrid-based investment fund consultant.

The government sees the pension funds as a way of channeling savings into industrial growth, although the funds have tended to diversify more into short-term government bonds since October. Insurance companies have moved aggressively into the pension fund market and expect to have 50% of the pension business by 1990. ■

Top 5 institutional investors

($ billions as of Dec. 31, 1986)

Banif (IM)	1.5
Gestemar (IM)	0.8
Gesbancaya (IM)	0.5
Banco Urquijo (CB)	0.35
Beta Capital (IM)	0.35

Source: InterSec Research Corp., London

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HOTCHKIS AND WILEY

OLYMPIC TRUST

Dutch market vibrant

By Paul L. Montgomery

AMSTERDAM, Netherlands — Old-timers on the Amsterdam Stock Exchange remember the prewar years, when the market was the world's most important after New York and London, and the oldest of the three.

The 50 years since then have seen many changes in institutional investors' attitudes, but the trading floor is still one of the most vibrant in Europe.

Amsterdam in the 1980s has seen an influx of outside investors trying to get monetary stability and undervalued equities. The market's price-earnings ratio rose to a peak of 13.7 in July 1987 and ended the year at 8.9, up from 5.9 at the end of 1982. That compares with a year-end average p/e of 11.4 for all European stocks.

Before Black Monday, it was estimated 50% of the turnover in the $74 billion stock market was accounted for by foreign investors, primarily from the United Kingdom, Switzerland and the United States. Since then, Japanese investors have increased their investments, overtaking U.S. investors who trimmed Dutch holdings.

But there is still a steady influx of interest from foreign investors seeking protection from dollar swings, steady returns and low-risk ventures. The market chalked up a 213.4% gain from July 1982 to the October drop, compared with the European average of 233.3%.

What makes the Netherlands different from other European investment climates is the power of pension funds and insurance companies, providing an anchor in such times of trouble as last October.

At the end of 1987, it was estimated the insurance companies and pension funds had almost $225 billion in capital, more than the net national income of $213 billion.

It is estimated institutions hold 15% of Dutch equities, while citizens hold 35% and foreigners 50%.

While it is true most of the pension capital goes into real estate and fixed-income securities, the market perked up in early 1988, rising 9.2% in the first two months, with institutional capital as a strong support. Private pension funds doubled their allocation to equities between 1980 and 1985, rising to 11.7% from 5.7%, according to government statistics.

Meanwhile, the loosening of government restrictions by the center-right government of Prime Minister Ruud Lubbers has presented opportunities for further opening of the market. ■

Top 5 institutional investors

($ billions as of Dec. 31, 1986)

Robeco (UT)	13.7
Nationale Nederlands (IN)	13.5
Gemeenschappelijk Administratiekantoor (IM)	7.6
Algemene Bank (CB)	4.3
Aegon (IN)	3.2

Top 5 pension funds

A.B.P.	63
P.G.G.M.	12.3
Philips	7.3
Shell	4.9
Metaalnijverheid	3.5

Source: InterSec Research Corp., London

Bad days for stocks

Australia pulls hard toward conservatism

By Geoffrey Lee Martin

SYDNEY, Australia — Domestic and foreign investors have pulled back from equities in the wake of the Australian market's horrendous October performance.

"There can be no doubt about it, the market has swung more toward conservatism," said Nigel Weaver, investment manager at Capita Financial Group Ltd., Sydney.

And foreign capital has fled the Australian stock market. TPF&C inc., Sydney, estimates foreign investors held between 25% and 30% of the market Sept. 30, but now hold between 7% and 10%.

Only in the past few weeks have foreign investors shown renewed interest in the Australian stock market, observers said.

Once one of the high-flying markets, the market fell 44.7% in October, according to the Morgan Stanley Capital International World index.

The institution-dominated market had risen 381.3% from July 1982 until the October drop, according to Morgan Stanley Capital International, New York. The market, which stood at $132 billion in U.S. dollar terms as of Sept. 30, plunged to $83 billion by year end.

But it has since recovered to $100 billion by the end of February, Morgan Stanley statistics indicate.

The October drop was especially hard on gold and other resource-related stocks. Because the Hong Kong and Singapore markets were closed the week of Oct. 19, foreign investors seeking to unload non-Japanese Pacific Basin stocks had only Australia open to them, said Brian Sherman, chairman-joint managing officer of Equitilink Australia Ltd., a Sydney-based money manager.

Since October, most Australian money managers have lightened their equity commitments, largely in response to pressure from clients.

As of Jan. 1, holdings of Australian stock had dropped to 29.1%, down from 36.3% on Oct. 1, according to a survey of pooled funds of major Australian managers by The Wyatt Co. Proprietary Ltd., a Sydney consulting firm.

Holdings of overseas equities also fell, to 20.2% from 23.2%, while domestic fixed-income holdings rose to 25.7% from 21.5%, international fixed-income increased to 1.5% from 0.3%, property grew to 15.7% from 13.7%, and cash increased to 7.8% from 5%, the survey found.

While much of the decline in stocks stems from the fall in market values, some managers have cut their equity allocations, explained Colin Westman, Wyatt's managing director for the Sydney office.

Managers have fled to blue-chip stocks. Since the crash, "second board" listings are not marketable, Mr. Westman said. "The emphasis is much more on fundamental value, getting away from using charts, using horoscopes," he said.

But the drop in equity holdings might have come at the worst time, if the market resumes its upward course, as it has in recent weeks, some said.

Some are betting on the revival of the Australian market.

Rothschild Australia Asset Management Ltd. has 45% of pension assets in domestic stocks. In the long run, equities will outperform other assets classes, and pension funds can afford to take the long view, said Peter Griffin, chief executive. The Melbourne-based firm runs $3.2 billion in pension assets.

One of the most aggressive investors is Equitilink, which has a 66% equity position, four-fifths of which is in Australian stocks. The firm manages nearly $1.9 billion in total assets, of which about 20% is pension assets.

Mr. Sherman bases his belief the market will surge on several factors: a drop of 200 basis points in long-term interest rates since the crash; the Australian budget surplus; the decline during the past three years in the current account deficit; and the inflation rate, which has fallen 300 basis points during the past year to 6.5% to 7% level.

But there might be a cloud on the horizon for the $45 billion to $60 billion Australian pension market.

To offset an expected cutting of the corporate income tax rate, the government has signaled it might seek some type of tax on funds.

But any word on that likely will wait until after the Australian government issues its midyear budget proposals in May. ■

Top 5 institutional investors

($ billions as of Dec. 31, 1986)

B.T. Australia (MB)	2.4
Westpac Investment (CB)	2.3
Australian Mutual (IN)	2.1
National Mutual Group (IN)	1.9
Wardley Australia (MB)	1.2

Top 5 pension funds

State Board/N.S.W. Superannuation Fund Investment Trust	3.3
Commonwealth Bank	2.6
Public Authorities/N.S.W.	2.5
Westpac	1.8
	1.3

Source: InterSec Research Corp., London

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Change hits France

By Paul L. Montgomery

PARIS — Financial markets in France are in the midst of a revolution almost as far-reaching as the "off-with-their-heads" version of 200 years ago.

France has been privatizing nationally owned companies, increasing the number of individual shareholders. At the same time, market reform is helping the traditionally protected French market prepare for the barriers-down European economic integration scheduled to start in 1992. And development of a private pension system will increase savings and investment.

When the Conservative government was elected two years ago, it announced an ambitious program of privatization and market reform. The banks and industries returned to private hands provided a bonanza for the market, particularly because the early shares were undervalued and gave ordinary investors the idea there was money to be made.

Top 5 institutional investors

($ billions as of Dec. 31, 1986)

Banque Paribas (CB)	14.5
Assurances Generales (IN)	12
Banque Nat'l de Paris (CB)	10
Societe Generale (CB)	9.8
Groupe des Assurances (IN)	7.9

Source: InterSec Research Corp., London

Consequently, the number of French citizens owning stock has risen to more than 7 million compared with 1.7 million 10 years ago. In addition, the law limits foreign purchases to 20% of shares in any privatized company.

While October's volatility held up for three months the privatization of Compagnies Financieres de Suez, the holding company for Banque Indosuez, the privatization campaign is back on track.

The government, when elected, also decided to break up the monopoly on trading held by a select group of brokers, a move that should foster modernization of the securities industry. Beginning this year, banks were allowed to buy up to 30% of a brokerage. This will rise to 100% in 1990.

By 1992, any financial institution or service firm, foreign or domestic, will be free to trade on the Bourse, subject to ministerial review.

The results already are being seen in a professionalization of the market, with emphasis on research and strategy and a premium on international contacts, said Francois Sureau, a director of Compagnies Reunies Europeannes, Paris.

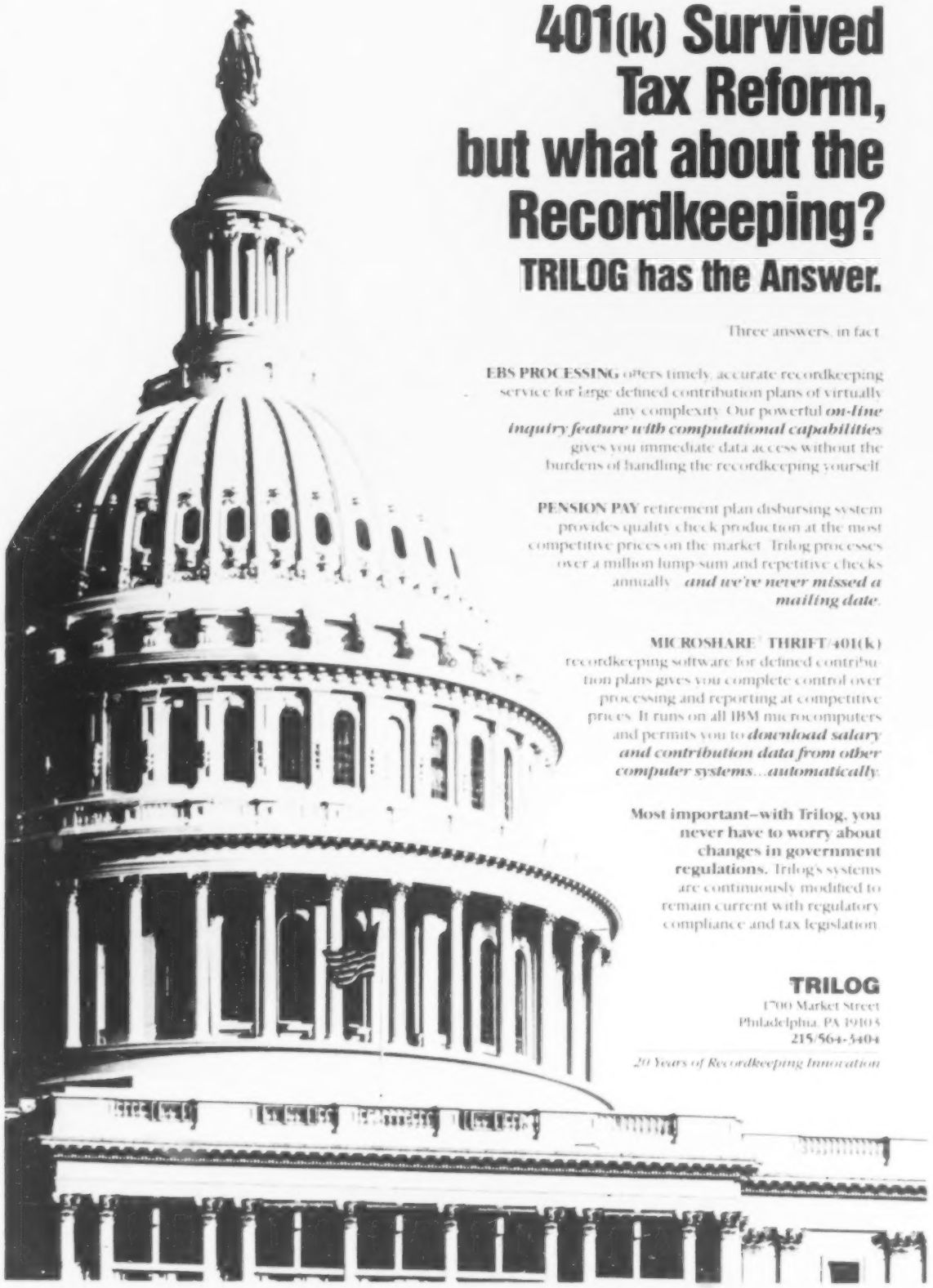
The sophistication is being felt in London, where trading of French shares has dropped to less than 9% of volume from about 15%, said Alain Dufour, partner in the brokerage firm of Dufour-Koller-LaCarriere, Paris.

More and more, with 705 stocks worth $154 billion at year end on exchanges in Paris, Bordeaux, Lille, Lyon, Marseille, Nancy and Nantes, the emphasis is on speed and information. New products are springing up virtually overnight.

International asset management has become a forte of such banks as Banque Paribas, Dumenil-Leble Bank and Banque Indosuez; the futures market started about two years ago; and there is a market developing in venture capital.

Because France has an extensive national pension system, private funds are not yet a big factor in the market. But a year-old law, designed to encourage the development of a private pension system, provides tax incentives to funds and participants.

The most popular type of plan adopted under the new system is the open-end profit-sharing plan, where a company contributes a portion of profits above a certain level. Banks and financial institutions have built busy departments managing the trusts, which are required to invest at least 30% of their assets in French government bonds or French francs. ■



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Swiss stay in bonds

By John Parry

GENEVA, Switzerland — Any hopes that Swiss pension funds would turn to stocks from traditional bond investments were dashed Oct. 19.

The $132.5 billion Swiss stock market, which dropped 33.8% in the fourth quarter, had only begun to see significant stock purchases by pension funds, encouraged by a 1985 law allowing them to put up to 30% of their assets in equities.

"Any thought that institutional investors were going to become more adventurous after the advent of the (pension law) was swept out of the window by Black Monday," said Walter Ruegg, president of Swiss Volksbank, Bern. "What we're seeing now is a hunkering down in bonds and real estate — and a scenario where we wait to see what the U.S. market is going to do."

Swiss investors aren't likely to venture into foreign markets either. Peter Widmer, a member of the board of directors of Bank Julius Baer, Zurich, said, "There's going to be a considerable retrenchment, and the exposure in foreign markets, never very strong, is going to shrink even further."

Swiss pension funds have dropped their stock investments by two-thirds, reducing equities to 4% at the end of 1987 from 12% a year earlier. Bonds have increased by a similar proportion, to 39%. Other investments are in real estate, 18%; mortgages, 9%;

Continued on page 23

Top 5 institutional investors

($ billions as of Dec. 31, 1986)

Union Bank Switzerland (CB)	150
Swiss Bank (CB)	130
Credit Suisse (CB)	120
Swiss Volksbank (CB)	45
Banca/Svizzera Italiana (CB)	18

Top 5 pension funds

P.T.T. Schweiz	4.6
Migros	3.1
S.B.B.	2.6
Coop Schweiz	1.9
Sulzer Brothers	1.8

Source: InterSec Research Corp., London

Italians leaving money at home

By John Parry

MILAN, Italy — Before last fall, Italian institutional investors were in many ways hamstrung in their efforts to invest in foreign markets. After last fall, there didn't seem to be much point in doing it anyway.

But Black Monday did not have a pronounced effect on Italian investors' interest in foreign stocks, according to Benito Covolan, head of the securities department at Cassa di Risparmio delle Province Lombarde s.p.a., one of Italy's three largest banks.

"The Italian investor, when he wanted to get into foreign markets, didn't go to his bank or his broker," Mr. Covolan said. "He hopped in his car and went to Chiasso," Switzerland, home to large branches of all the major Swiss banks.

Although the Swiss banks won't say so officially, 90% of their clients are Italians — including institutional investors — who prefer to do foreign securities dealings in Swiss francs.

But institutional investors, by and large, are staying at home and staying conservatively invested in bonds — even though restrictions on transferring money abroad were lifted last year.

Despite their conservative investments, institutional investors are increasingly important to the $109.3 billion Italian stock market. Banks comprise 45% of the market; pension funds, 10%; and mutual funds, 30%, although this is shrinking because of redemptions since Oct. 19. The remainder is individuals.

The Italian government is encouraging the development of the $64 billion pension market, but 70% of the assets are in the conservatively invested Istituto Nazionale della Previdenzia Sociale, the equivalent of U.S. Social Security.

Top 5 institutional investors

($ billions as of Dec. 31, 1986)

Imigest (UT)	10.2
Primegest (UT)	6.2
Gestiras (UT)	4.1
Arca (UT)	3.6
Interbancaria Gestione (UT)	3.6

Source: InterSec Research Corp., London

A new employer-sponsored pension system for management employees started Jan. 1. Supplementing the state-run program, the new, supplementary pension system has brought new income to insurance companies, which largely run it so far. But because the plans are so new, there are not yet reliable estimates of their expected growth.

Insurance companies already have put more than 60% of the new assets into bonds, 30% in real estate and only 10% in equities.

"They're wary of getting into the market, and nothing they have seen since October has made them change their minds," Mr. Wagner said.

"Even though the market has turned upwards in the first two months of this year, insurance company investment managers remain very conservative."

While there is a move toward a more open investment policy in Italy as a whole, pension and mutual funds still have to ask permission from the Bank of Italy to invest abroad.

Most don't bother; Mr. Covolan said his research shows the funds, like the insurance companies, are more interested in the bond market. The pension fund at Mr. Covolan's bank has only 1% to 2% in West German bonds — although that might be increased — and most of the other major funds are estimated at having approximately the same proportion in German or other European stocks and bonds. ■

Swiss

Continued from page 22

domestic mutual funds, 8%; and 22% in loans to employees, according to Hans Kaufman, vice president of Bank Julius Baer.

The 1985 pension law permitted funds to invest up to 30% of their assets in stocks, with a ceiling of 10% of total assets in foreign stocks. Bond investments could equal 100%, with up to 30% in foreign issues.

Because many funds decided to take the plunge into stocks only a few months before the market fall, institutional investors will be even more cautious than before, said Felix Zulauf, first vice president of Union Bank of Switzerland, Zurich.

"The only thing I see as bucking this trend is that a few large institutional investors — banks particularly — have gone back into the equity market. . . . But it's not a major trend," he said.

The Swiss funds are becoming a larger force in the market, bolstered by the 1985 law's required participation by salaried employees. That rule will add $10.7 billion to $14.3 billion (15 billion to 20 billion Swiss francs) of new money to the funds each year, according to Mr. Kaufman. (The size of the pension fund market was not available.)

While some funds are turning to the safe haven of bonds, smaller pension funds are boosting their exposure to real estate, said Mr. Zulauf. But he warned that market is shrinking.

"This is a small country and office space in major cities is already at a premium," he said. "Not only that, but interest rates are low; I think we're going to see a switch away from interest in real estate by the funds in the next year." ■

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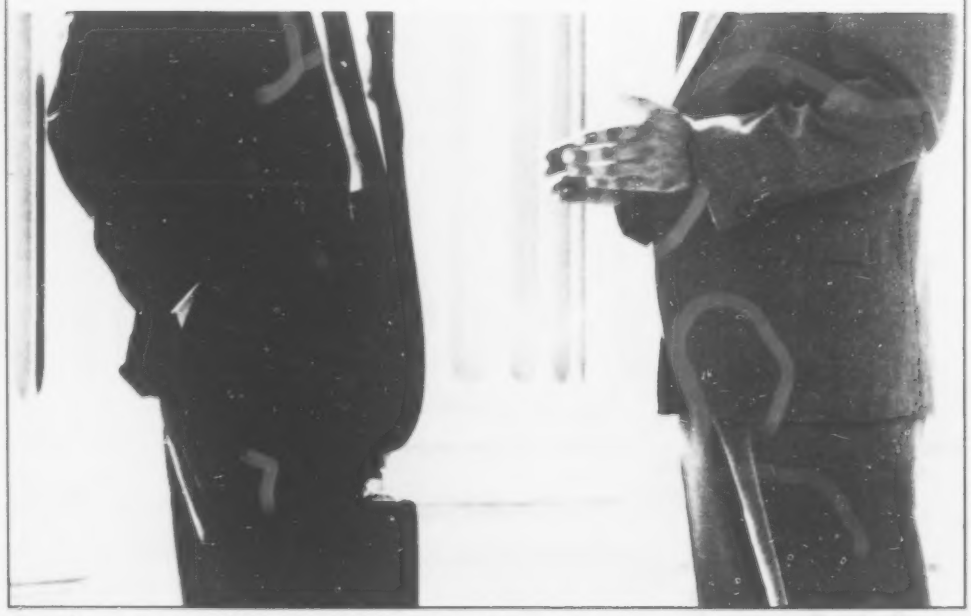

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Japan looking

Continued from page 17

As of March 1987, financial institutions owned 41.7% of shares in listed companies, while corporations owned 24.5%. Individual ownership, which has been declining steadily since 1949, stood at 23.9%. The remainder was held by investment trusts, foreigners and other investors.

Government intervention has bolstered beliefs by Japanese institutional investors that the domestic market is the safest place to invest. Besides the Ministry of Finance's easing accounting rules for tokkin funds, it has taken several other actions to prevent the market from sagging. During the crash, it reportedly called on the support of Japan's Big Four securities firms, while the Tokyo Stock Exchange reduced margins for individuals. Since then, the government has allowed the creation of two trust funds to invest in financial services companies, and now might consider postponing the next sale of Nippon Telephone and Telegraph Corp. stock.

Between the intervention and a strong economy, the domestic markets have responded well, and the Nikkei index now is at levels within 5% of last year's peak of 26,646.43.

While domestic markets appear safer, they cannot absorb Japan's burgeoning mountain of cash.

Efforts to export yen have been promoted by the government. Consultant George Curuby, principal of Curuby & Co., Tokyo, said, "In response to the precipitous strengthening of the yen since the fall of 1985, the government has taken an increasingly liberal attitude to easing the (overseas investment) restrictions on the Japanese institutional investors."

"The key point is that the relaxing of the ceilings on investment really comes together with the efforts to promote capital outflows to reduce the yen's appreciation. Most institutional investors can now put large amounts overseas," he said.

Despite October's volatile market, Japanese overseas holdings remain at high levels. Net holdings of foreign stocks as recorded by the Japan Securities Dealers Association were $4.6 billion at the end of 1987, compared with $2.6 billion at the end of 1986. Similarly, foreign bond holdings were $114.9 billion at the end of 1987 compared with $89 billion in 1986.

But efforts to keep assets flowing overseas will have to overcome a renewed conservatism, money managers said.

"During the first nine months of 1987, I think Japanese investors were becoming more tolerant of risk," said Dennis H. Ferro, president of Japan Bankers Trust Co. Ltd., Tokyo. "We had begun to see a shift from U.S. Treasury bonds to the equity market, which is a reflection of an increased ability to take risk at that time." Now, however, Japanese investors are returning to earlier attitudes, he added.

Foreign exchange losses also have battered Japanese investors. Since the fall of 1985, the U.S. dollar has lost half of its value against the yen, causing Japanese to absorb huge losses on their U.S. Treasury bond investments.

Akira Shimizu, executive managing director of Nomura Securities Investment Trust Management Co. Ltd., Tokyo, said: "There are also foreign exchange risks and conflicting views about the development of the U.S. economy. All in all, there's too much uncertainty at the moment."

But despite the problems, there already are signs of reawakening interest in overseas investments, according to Kiyitoshi Aiba, director of investment management, Yamaichi International Capital Management Co., Tokyo. "Investing outside Japan is important to avoid the unnecessary risks entailed in investing only in Japan, especially as the correlations between Japan and other markets are very low." ■

Home

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become net buyers of Japanese stocks for the first time in 22 months, pumping $3.504 billion into Japanese equities in January and February alone.

"This has coincided with (the level of) the Japanese market reaching within 3% to 4% of its old high," noted Peter Green, president of James Capel Inc., New York.

"The higher Japan goes, the more pressure there is to invest there."

Japanese investors are continuing to buoy the Tokyo stock market and a number of supportive measures by the government will further boost liquidity. Even a small spill of that liquidity abroad in the near term would significantly affect the flow of investment funds worldwide.

Japanese individual investors are snatching up equities in the United States, with a new interest in small-cap stocks, said Shigayo Kawata, vice president of Daiwa Securities America, New York.

Japanese investment in Europe has been quite moderate relative to their wealth and their U.S. investments.

"As we look ahead, I would expect to see that increase as Japan becomes more comfortable with European bond and equities and disenchanted with the currency risk of investing in U.S. dollars," said Gilman C. Gunn, head of international fixed income research, Banque Paribas Capital Markets ■

Gross activity in non-domestic equities by investors
($ billions)

Market	1st-3rd qtr. 1987	1986
Canada	36.5	26.3
France	**	32.5
Japan	278	185.9
Britain	95 *	94.5
U.S.	359.2	277.3
Germany	35 *	77.2
Other	122 *	47.7
Worldwide	925.7	741.4

* Estimate from first-half figures
** Included in "Other"
Source: Salomon Brothers Inc., Statistics Canada, Treasury Bulletin, Bank of Japan

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Railroads on different tracks

Union Pacific Realty aims for status as top developer

By Joanne Friedrick

Union Pacific Realty Co., a subsidiary of railroad and energy concern Union Pacific Corp., wants to be one of the top 25 developers in the nation.

To achieve that, the company is expanding into three new areas of the country and will spend more than $850 million on developments within five years, said Edgar J. Gansz Jr., president and chief operating officer.

Mr. Gansz, who is based in the company's Omaha, Neb., office, said Union Pacific Realty annually will develop 3½ million square feet of primarily speculative office and industrial space in its target areas.

Suburban Chicago and Morris County, N.J., offices were added in 1987, a Washington, D.C., operation is scheduled to begin in the second half of 1988 and Dallas, Atlanta and Boston operations are on the drawing board.

Meanwhile, development in Los Angeles/Ontario, Calif.; San Francisco/Oakland; and Seattle will continue, but further activity in Denver and Houston is on hold.

Marilee Tatalias, director-real estate operations in the Oak Brook, Ill., office, said in building its new portfolio, the company is looking to achieve returns "that are more akin to entrepreneurial developers — low double digits."

Mr. Gansz said leveraged, after-tax, internal rates of return for low-risk properties (e.g. build-to-suit office) would be 13%; for high-risk buildings (e.g. industrial, high-tech speculative suburban), 19%.

Observers attribute Union Pacific Realty's pro-growth attitude to the hiring of New York-based Chairman Arch Jacobson, former Prudential Realty president, in 1986 and to the subsequent reorganization of management in 1987, which put Mr. Gansz, also an alumnus of Prudential Realty, in the president's spot.

Mr. Gansz said the search for Mr. Jacobson was a demonstration of Union Pacific's commitment to real estate. "One of the reasons we're in this business is that we realized real estate over the long term can be profitable. Union Pacific is a growth company. Our real estate undertakings will contribute to our corporation's growth."

The parent company's board "has made a significant commitment; it was not made lightly," he said.

The board's attitude is a significant departure; in the past, board members "were doubting Thomases who weren't secure enough to take risks," said Bob Dunn, former president of Missouri Improvement Co., the real estate subsidiary of Missouri Pacific Railroad that merged with Union Pacific in 1982.

Union Pacific Realty "is now structured so real estate doesn't take a back seat," he said.

"The railroad was getting more than the lion's share of the capital" when real estate was handled through Upland Industries by former railroad management, noted Mr. Dunn, now a broker with James T. Barry Co., Milwaukee.

Photo by Mary Hertehy

Marilee Tatalias of Union Pacific Realty's Chicago office inspects the site of the former Aurora Downs racetrack and future office-research and industrial parks.

Robert Kevin Brown, vice president-corporate services at Carter & Associates, Atlanta, and a 30-year veteran in corporate real estate, called Union Pacific Realty's recent hirings and new approach — adding markets outside its historic development areas — "the best possible way to go about it."

Mr. Gansz emphasized the realty company "will be a self-funding mechanism." In addition to implementing an existing

Continued on page P23

Mission Bay, a 300-acre project in San Francisco, will be retained by Santa Fe Pacific Realty Corp. even though the realty firm must sell $800 million to $1 billion worth of holdings to help finance a restructuring of the parent company.

With takeover looming, Santa Fe sells, builds

By Joanne Friedrick

Santa Fe Pacific Realty Corp. is traveling parallel tracks while at least two suitors are fighting over control of its parent.

Executives of the San Francisco-based real estate subsidiary of Santa Fe Southern Pacific Corp., Chicago, are juggling a mandate to sell $800 million to $1 billion worth of holdings by year end to help finance a $4.695 billion restructuring with an ongoing development program that makes its parent such an attractive takeover target.

To help pay off the loan for a $25-per-share cash payment to shareholders and a planned $5-per-share subordinated debenture that make up the restructuring, Santa Fe Pacific Realty will sell 3.6 million square feet of its 8 million square feet in developed and fully leased buildings this year, with the goal of having all the buildings sold by 1992.

These developments include light industrial, distribution and warehouse buildings, low-rise offices, research and development facilities and retail centers, primarily in Southwest and West Coast states.

Although the figures are subject to change, Santa Fe ultimately is expected to sell 123 acres of its 500 acres in major projects; 6,650 acres of surplus land; all of its 150,000 acres of land grant agricultural holdings in the San Joaquin (Calif.) Valley; 500,000 square feet of miscellaneous property; and 4,900 acres of developable land.

Some sales, including that of agricultural land, had been under way before the restructuring.

Joseph O'Connor, president, Copley

Continued on page P22

Trends show soft market will stay awhile

By William Fulton

Even though demographic and economic trends suggest the current soft office market will be more serious than merely a cyclical downturn, America's real estate developers don't seem to be paying much attention.

Among the warning signs:

- The flood of young people into the labor force virtually has stopped, sending job growth toward a 50-year low.
- More people are working at home, though no one knows for sure how many.
- On Wall Street and elsewhere, brokerage and investment houses are laying off white-collar workers, while the office work place is just now increasing worker productivity the way factories did much earlier.
- And David Birch, a professor at the Massachusetts Institute of Technology, Cambridge, Mass., predicts the United States will require only half as much office space in the decade ending in 1995 as was built in the decade ended in 1985.

Excess office construction by region: 1975-85

Region	Need (mil. sq. ft.)	Excess (mil. sq. ft.)	%*
Mountain	64.4	38.3	43.5
W.S. Central	130.6	73.3	37.4
Pacific	204.2	103.3	32.4
E.S. Central	25.4	21.3	20.1
United States	893.5	452.4	19
S. Atlantic	164.8	66.1	18.6
E.N. Central	68.1	64.9	14.2
W.N. Central	43.2	23.1	14
New England	70	14.1	8.9
Middle Atlantic	125.6	47.5	8.8

* Excess construction as a percentage of total 1975 office supply
Source: America's Office Needs: 1985-95, by David Birch, Arthur Andersen & Co., Chicago

Despite the warning signs, the value of building permits issued in the United States in 1987 declined less than 10% from 1986, and was greater than in any year prior to 1984, according to San Francisco real estate consultant Stephen E. Roulac.

As George Sternlieb, director of Rutgers University's Center for Urban Policy Research in New Brunswick, N.J., puts it: "There are probably not enough bottoms to fill all the desks in all the office buildings projected to be built in America."

The likely result of continued development in light of a fundamental shift in work habits will be a "crisis glut" in the early 1990s, with vacancy rates running 25% to 40% in some cities, large amounts of fairly new space being dumped onto the sublease market at bargain-basement prices, and — finally — a precipitous drop in office construction.

Because the recent boom in office development has attracted many new firms to the field, the number of casualties could be much higher than it was during recessions in the 1970s and early '80s.

The tremendous growth in office demand during the past few years has come about partly because of the increase in the labor force and partly because of the well-publicized conversion to a service economy. But now the Baby Bust is driving down labor-force growth, and real estate experts say the economic conversion is largely over, with office layoffs likely to continue for some time.

Labor-force growth in the '70s was remarkably high, running at almost 3% per year. Close to 3 million people — mostly Baby Boomers and women — entered the job market each year.

By the early 1990s, however, labor growth will be half what it was in the '70s, due in part to the low birth rate since 1965 and slower growth of women in the labor force, the Bureau of Labor Statistics predicts. Already, younger women are in the labor force in comparable numbers to men and, by the year 2000, the "working woman" phenomenon will have topped out completely.

These demographic trends have profound implications for office employment, which, in turn, dictates the demand for office space.

The Birch report, issued jointly by the MIT Center for Real Estate Development and Arthur Andersen & Co., was based mostly on estimates of job growth over the next 10 years. It contained some truly frightening numbers for office developers:

- Washington and New York will be virtually the only U.S. cities requiring as much office space in the next decade as they constructed in the previous decade.
- Only a few other major markets — Detroit, Baltimore, Philadelphia and Atlanta — will require even half as much space, while most Southwestern and Pa-

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Union Pacific

Continued from page P3

cash balance to finance acquisitions, plans are to sell "portions of the portfolio" to provide additional cash to continue development undertakings.

Estimates are the turnover could involve half of the new and existing properties — it already holds about 75 business and industrial parks in 22 states — with profits going to new development and to fatten the parent company's coffers.

Mr. Gansz said the asset management group also will add capital by selling off about 10,000 acres of raw land, mostly in markets the company is leaving — Salt Lake City, Cheyenne, Wyo., St. Louis and Kansas City, Mo.

Although $70 million to $80 million of land will be sold, up to $60 million will be spent on acquiring new land.

"We own our lands . . . We buy lands with our cash. What we plan to do is approach lenders and money sources primarily for construction and permanent financing. We'll continue to own our land. We don't plan to leverage land," Mr. Gansz said.

Union Pacific Realty undertakes joint ventures more as an exception. "Our strength is as developers," he noted.

"We would rather control 100% of the real estate, take 100% of the risk, and get 100% of the profit," Ms. Tatalias added.

Still, Union Pacific Realty will consider a joint venture if that's the only way it can get the land it wants, such as in parts of the Northeast, where there is a severe shortage of industrial land.

"We wouldn't be a passive investor," but the developing partner, said Tom Giannone, director-real estate operations.

Mr. Giannone, who joined Union Pacific Realty from Prudential Realty in July, acknowledged "there isn't much land for any real estate projects in New Jersey. We're looking at some pretty difficult sites now, sites that will take years to develop."

And he is looking at all projects warily. "I can't afford to have the first project get stuck in a down market," he noted. "But I think the market is still strong in several areas."

His five-person operation in Short Hills, N.J., is looking at developing in such places as Connecticut, upstate New York and northern New Jersey, as well as the highly developed Morris County area.

By the end of 1988, he said, he plans to have two projects under construction and another two office and industrial projects going through the approval process.

The first under contract is the 100-acre Triumph property in Florham Park and East Hanover, N.J., which will be developed into offices.

"We target projects in Chicago that have the best opportunity," she said. Markets might be softer and demographics weaker than they once were, Ms. Tatalias said, but developers "that have the assets to compete will do well."

She cited the Naperville project, saying that area "has good absorption numbers." When the office building comes on line in 1989, she said, there will be a "great window."

She also sees no problem with finding projects to meet Union Pacific Realty's goal of about $200 million in new developments around Chicago in the next five years. She has concentrated her search in the counties outside Chicago and is just now "tiptoeing into Cook County," in which Chicago is located.

> "We own our lands . . . We buy lands with our cash. . . . We'll continue to own our land. We don't plan to leverage land."
>
> Edgar Gansz
> Union Pacific Realty

From her suburban Chicago office, Ms. Tatalias and a staff of five are handling three major development projects while continuing to search for additional opportunities.

In January, Union Pacific Realty purchased 94 acres in South Barrington, Ill., from Beatrice Co. for an office campus. It already had contracts to buy acreage in the Naperville (Ill.) Office Park for a 135,000-square-foot office building and for the former Aurora Downs racetrack in North Aurora, Ill., which will be used for a 27-acre office-research park and a 70-acre industrial park.

Unlike Union Pacific Realty projects in California, which are primarily distribution facilities, Ms. Tatalias said Chicago-area ones will be light manufacturing and light industrial, with some back-office facilities.

Mr. Gansz said a search is going on now for a senior person to head the Washington office. Operating that office is contingent on having the capital, the staff and a sufficient market for a five- to seven-year development period.

Despite the move into new markets, 75% of this year's projects will be on land already owned. "A significant contributor will be in California," Mr. Gansz said, where 1.4 million square feet will go up in the Ontario area.

Union Pacific Realty also recently spent $60 million on 275 developable acres in Carlsbad, Calif., that was held by Carlsbad Research Center Associates, a partnership of Urban Diversified Properties (a division of Aetna Life & Casualty Co.) and the Koll Co., Newport Beach, Calif.

Trends show

Continued from page P3

cific cities will require only a fraction of the space they constructed in the last decade.

In fact, Mr. Birch predicts an enormous drop in demand for "primary" office space (that is, space in office buildings, not in buildings used primarily for some other purpose) in California. Although California led the nation with 265 million square feet of primary office space constructed between 1975 and 1985, Mr. Birch forecasts the state will need only 71 million square feet over the next decade.

"Past gluts have been absorbed fairly quickly by a continued and rapid expansion of the economy," Mr. Birch said. "This one won't be."

If demographic changes were all that America's office developers and investors had to worry about, the situation would be bad enough. Making it worse, however, is the economic restructuring beginning to roll through the white-collar economy.

When economic restructuring hit manufacturing in the early '80s, the office market benefited because a big shift from industrial to office jobs resulted. Now things are different.

"The shift is behind us," said Christopher B. Leinberger, managing partner of Robert Charles Lesser & Co., a real estate consulting firm in Los Angeles.

Statistics compiled by the real estate research department at Salomon Brothers Inc., New York, show white-collar employment growth reached its peak in 1984, with a 7.6% annual rate. By 1987, it had dropped by half, to about 5%, and Salomon's David Shulman is predicting a further 30% drop in the growth rate in 1988.

Beyond a slowing of the economic conversion to office work, however, is the corporate reorganization now sweeping the financial, insurance, and banking industries. "The cost-control ethic is shifting to the white-collar world," Mr. Shulman said.

Though good forecasts are hard to come by, most real estate experts agree offices have lagged far behind factories in improving worker productivity. But as they catch up over the next few years, demand for office space will be severely dampened.

"Part of the reason for corporate reorganization is that there's plenty of room to cut," said Rutgers' Mr. Sternleib.

As the cost-control ethic spreads, it could cut into office demand other ways. With vacancy rates high and rents low, many office businesses have expanded the amount of square footage each worker uses. "A 10% reduction in the amount of space per worker, and you'd have a very ghastly glut of office space," Mr. Sternleib warned.

And because of layoffs and per-worker reductions, a large amount of excess space in offices constructed in the 1980s is likely to hit the sublease market in the early 1990s, driving rents down further.

At the same time, employers are finding cheaper ways to provide space for office workers. Already, some suburban industrial parks are fighting with office buildings for tenants.

"What used to be warehouse or distribution space may start housing office workers at a very low cost," said Larry Wofford, director of research at Office Research Systems, a real estate marketing analysis firm in Tulsa, Okla.

The other possible alternative to the office, of course, is the home. Edgar O. Cheney Jr., a building analyst with United Technologies Corp., Hartford, Conn., has calculated that if 10% (or about 6 million) of America's white-collar work force worked at home, office demand would drop by 1 billion square feet.

Still, Americans have not yet shown a strong inclination to be full-time home workers. The Bureau of Labor Statistics estimates that in 1985, only about 2.2 million people (less than 2% of the labor force) worked at home full time, only half of whom were employed by an outside company.

"The potential to work at home gets overstated," said Bureau economist Frank Horvath. "For many occupations, you spend a good part of your day in meetings, or you're a part of a production team." Yet real estate analysts agree a home office is far less expensive than any other alternative — even if it means buying a bigger house.

It's possible, though perhaps unlikely, some employers will start subsidizing employees who want to operate from home. More likely is a further "decentralization" of the economy into smaller companies; more workers will be their own bosses and could choose to work at home.

But if certain other trends emerge, office demand projections based on demographic changes could be off by a wide margin.

For example, as workers become more scarce, employers probably will turn to people they now deem more marginal. According to Nation's Business, by 2000, 80% of all entrants into the work force will be women, members of minority groups or immigrants, groups whose labor force participation currently is low.

"No longer can you create a ratio that says, 'Because demographic trends say X, demand for office space is going to be Y,'" said Sanford Goodkin, director of real estate for the Peat Marwick/Goodkin Consulting Group, San Diego.

In particular, Mr. Goodkin believes foreign employers, such as the Japanese, might feel less bound by American prejudices in their search for workers.

Nevertheless, the hiring of marginal workers is not likely to offset the space-saving efforts of corporate reorganizers and other trends that will drive down demand for office space in the next decade.

And sooner or later, developers — or, more likely, their lenders — will catch on. So far, office developers have adapted to a world with higher vacancy rates, mostly because office buildings are still valuable as saleable assets.

"Pro formas have changed," said Mr. Leinberger of Robert Charles Lesser. Developers now assume a longer absorption time and set aside more interest reserve to make up the difference, he said.

"The reason they do that is back-end payoff," Mr. Leinberger added. "Offices continue to be investment darlings."

But this attitude isn't likely to last forever.

"A number of our clients are institutional lenders, and I know they're closing their pocketbooks," said Raymond Torto, a principal with Coldwell Banker/Torto Wheaton Services in Cambridge, Mass.

"Ultimately, the space market will determine the value of real estate."

And given the crisis glut that's likely to hit, the market-based value isn't likely to rise very much. ■

Plan enrollment low

Public workers slow to accept 401(k) equivalent

By Fred Williams

While a substantial majority of state and local government employers offer the public sector equivalent of a 401(k) salary reduction plan, only a small minority of eligible employees are participating.

According to a recent survey by Buck Consultants Inc., New York, only 16% of eligible employees are enrolled in section 457 plans compared with 79% participation by salaried employees and 59% by non-union hourly employees in 401(k) plans.

"Our survey demonstrates that 457 plans are still in their infancy with respect to employee participation," said Joseph G. Metz, director of governmental legal services for Buck. Mr. Metz said one reason for the low participation levels is that employers are not allowed to make matching contributions.

Section 457 plans permit state and local government employees to shelter from current federal income tax the lesser of 25% of income or $7,500.

Of the 98 public employers surveyed by Buck, 69 offer section 457 plans.

Several public-sector benefit plan executives blame the lack of interest on difficulties in communicating to employees, the diversity of public employers (varying public agencies) associated with a particular plan and the lack or overabundance of investment options.

In Ohio, about 25% of eligible employees are participants in the $650 million plan, according to Ray McLaughlin, executive director of the Ohio Public Employees Compensation Board. Its relatively high participation rate is due to a strong promotional effort by the state, he said.

"I came here from the Arkansas program. There, there was no aggressive marketing or promotion of the plan. It's treated as a fringe benefit and employees almost had to ask for it before it was offered."

"In Ohio, the board chose to expand the program to all employers in the state — now about 500 different political subdivisions, and to promote it aggressively."

Ohio's investment options are a universal life program, a fixed annuity, a variable annuity and six mutual funds ranging from equity growth to income-oriented bonds. The state is seeking additional investment options.

In Texas, the participation rate among eligible employees is only about 7%, said Deborah Powers, plan administrator. Part of the reason might be the $115 million Texas plan offers participants a phenomenal number of managers and investments. Participation is restricted to state employees.

"We are the only plan in the nation that has 140 investment managers to choose from," said Ms. Powers. And with some of the eligible financial institutions offering 10 to 12 investment options, the employee might be overwhelmed, she said.

The number of financial institutions exploded following a 1975 opinion from the Texas attorney general saying the plan could not exclude institutions authorized to do business in Texas and who applied to participate in the program.

Colorado has about 10% participation in its 457 plan, according to Helen Erickson, administrative officer. Colorado's plan also is not available to municipal employees.

Colorado offers participants a savings option at a local savings and loan, Treasury bill and short-term money market options, an annuity program and six mutual funds. A recent survey indicated participants want additional investment options in the equity and fixed-income areas, Ms. Erickson said.

"One reason employees aren't participating fully is that they don't know about the program," she said. "Those that do know seem to really appreciate it."

She said Colorado now contacts each new state employee and provides information about the plan, which has about $50 million in assets.

The $146.6 million Illinois state plan has about a 15% participation rate, said Patrick Foley, spokesman for the Illinois Department of Central Management Services, Springfield.

The Illinois program offers participants six mutual funds. Mr. Foley said a lack of matching contributions from the state probably is the reason for the low participation.

Buck's Mr. Metz said participation levels in 457 plans should begin to increase soon.

"As more funds are established and deposits grow . . . participation will increase. I see a continued refinement of investment strategy and a parallel to the private sector, where 401(k) plans generally supplement and complement defined benefit plans." ■

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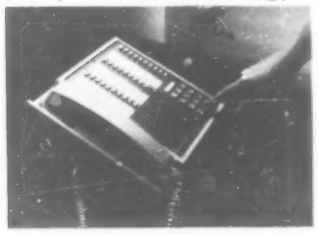

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PENSIONS & April 4, 1988

InvestmentAge

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Institutional investors are expected to play a key role in the heated proxy battle between Gillette and The Coniston Group.

Gillette fight to center on institutions

By Marcia Parker

BOSTON — Institutional investors will determine the outcome of the battle between Gillette Co. management and The Coniston Group for control of the company.

The battle is reaching fever pitch as the two sides vie for the votes of pivotal institutional investors, who own 40% to 50% of the shares, at the company's April 21 annual meeting.

The Gillette/Coniston duel is being hailed as the proxy contest of the season. It has all the markings of a classic proxy struggle involving a household-name company and a lesser-known raider.

At the same time, Boston-based Gillette's stock has been climbing recently because the company has been the target of recurring takeover rumors. The stock closed March 30 at 44 per share. Philip Morris Cos. Inc., New York, is considered a potential suitor, but signs of a bidding war have yet to surface.

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PROXY
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PROXY

***Pensions & Investment Age*'s special look at the issues of the 1988 proxy season continues in Financing — Page 25.**

Small stocks bounce back

By Joel Chernoff

After 4½ years of severe underperformance, small- and medium-capitalization stocks finally might be rebounding.

Whether the beginning of a long-term turnaround or just a blip, first-quarter returns of small-cap issues nearly tripled those of larger-cap stocks: 13.37% for the Nasdaq industrial index of over-the-counter stocks vs. 4.78% for the Standard & Poor's 500 index.

Some believe a reversal has started, but still have their fingers crossed.

"We think it has (turned around), but of course we thought so in the first quarter of '87," said Robert Zuccaro, president of Stamford, Conn.-based Target Investors Inc., which manages $200 million in small-stock portfolios for pension funds.

While many pension fund executives are studying the issue, only a few are adopting a small-cap bias for their stock portfolios.

"My personal view is that the S&P is not the right portfolio to own at this time," said Robert Shultz, vice president-pension asset management at RJR Nabisco Inc., Atlanta, who oversees the $2.4 billion pension fund.

Mr. Shultz said the average capitalization weighting of the equity portfolio is slightly lower than that of the Russell 3000 index.

Some managers already have altered their portfolios. Jeffrey Diermeier, managing director of First Chicago Investment Advisors, Chicago, said the firm overweighted the small-stock portion of its $2 billion in domestic equity assets starting late last year. Since small stocks started rebounding in December, small companies have corrected 20% to 25% of the underpricing that had occurred since mid-1983, he said.

Many investment experts believe a turnaround in small-cap performance is long overdue. They point to such reasons as the undervaluing of small-cap stocks and overvaluing of larger-cap issues; the cyclical nature historically of small-cap performance; the return of merger activity to the small-cap area; and the demise of technical factors that had buoyed S&P stocks.

Since mid-1983, small-cap issues have greatly underperformed S&P issues. The Russell 2000 index — which includes stocks with capitalizations between $25 million and $300 million — produced a meager compound annual rate of return of 1.4% between July 1, 1983 and Dec. 31, 1987.

By comparison, the larger-cap Russell 1000 index and the S&P 500 returned 12.2% and 13.1%, respectively, during that period.

In the long run, however, small-cap stocks have topped large issues by two percentage points a year from 1926 to 1986, returning 12% against 10% for the S&P 500, according to research by Dimensional Fund Advisors Inc., Santa Monica, Calif.

Since their relative valuation peak in mid-1983, small- and medium-cap stocks have been hurt by a variety of influences, including the rise of indexed stocks, which mostly focus on the S&P 500, and the increase in foreign purchasers, who favor household names that tend to be large-cap stocks.

An analysis by Dennis J. Tritten, a vice president at Frank Russell Co., Tacoma, Wash., showed other reasons for smaller stocks' weaker performance: failure to meet high growth expectations; elimination of lower capital gains tax rates; a recession in the technology sector during 1985 and 1986; and a shift by

Continued on page 34

Small-cap vs. large-cap returns

	Russell 2000	Russell 1000	S&P 500
1/79 - 6/83	32.7%	20.7%	19.3%
7/83 - 12/87	1.4	12.2	13.1
1/79 - 12/87	16.0	16.0	16.2

Source: Frank Russell Co., Tacoma, Wash.

Funds buy out firm

Delaware Management price 3 times revenue

By Joel Chernoff

Some tax-exempt institutional investors will own a piece of Delaware Management Co., the first money management firm to be the target of a leveraged buy-out.

Delaware Management, Philadelphia, is being purchased for about $300 million by the firm's management and Legend Capital L.P., a New York leveraged buy-out fund in which several institutions are limited partners.

Limited partners include the United Technologies Corp. pension fund, Hartford, Conn.; the Massachusetts Institute of Technology retirement fund, Cambridge; and the Brown University endowment fund, Providence, R.I. Other investors include Chemical Bank, New York; Manufacturers Hanover Trust Co., New York; Prudential Insurance Co., Newark, N.J.; Security Pacific National Bank, Los Angeles; Toronto Dominion Bank, Toronto; Primerica Inc., Greenwich, Conn.; and Irving Trust Co., New York.

The highly leveraged purchase of Delaware Management, which manages $13 billion in institutional assets and $5 billion in mutual fund assets, is pending approval by the boards and shareholders of the company's 16 mutual funds.

The price tag for Delaware Management shows there is significant interest in buying high-quality firms despite last year's stock market crash and weaker prospects for growth in the pension market.

Price multiples paid for money managers declined to 1.7 times revenue at year-end 1987 from a peak of 5.4 around March 1987 (*Pensions & Investment Age*, March 7).

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LATE NEWS

JMB buying Celanese building

NEW YORK — JMB Institutional Realty Corp., Chicago, has an agreement with the Royal Dutch Shell Pension Fund Foundation, The Hague, Netherlands, to acquire the 1.7 million-square-foot Celanese building in midtown New York for approximately $340 million.

JMB's commingled funds Group Trust IV and Endowment and Foundation Limited III will finance about 51% of the purchase; separate account clients are to finance the remainder. At press time, it was not known what separate account clients had committed to the deal.

3rd partner leaves Brignoli firm

NEW YORK — Duane Roberts, partner, has left Brignoli, Curley & Roberts Associates, effective last week.

He is the third partner to leave; Jac Curley left the firm in December and James Karanfilian, in January. Their departures were due to "philosophical differences" with Richard Brignoli, the other partner and majority owner, on the operation of the firm, Mr. Roberts said. Their plans are undecided, he said.

Brignoli Models Inc., of which Mr. Brignoli is president, has a controlling interest in Brignoli, Curley & Roberts. Brignoli Advisers Inc., a subsidiary of Brignoli Models, will take over marketing and client servicing for Brignoli, Curley & Roberts, said William M. Morris, partner in Brignoli Models and president of Brignoli Advisers.

Both Brignoli, Curley & Roberts and Brignoli Advisers market quantitative equity strategies developed by Brignoli Models. Brignoli, Curley & Roberts runs $800 million in tax-exempt assets. Brignoli Advisers manages $200 million in corporate cash in a stock index arbitrage strategy. All the firms are in New York.

Executive joins Rogers, Casey

STAMFORD, Conn. — Paul H. Fullum, formerly head of direct investment for Progressive Corp., Cleveland, will become managing director-investment supervision at Rogers, Casey & Barksdale Inc., effective Tuesday.

Mr. Fullum could not be reached for comment by press time.

Asset manager changes reported

• Two corporate pension funds have made their first commitments to overseas investments, while a third fund hired its first active international manager.

The $246 million pension fund of Burroughs Wellcome Co., Research Triangle Park, N.C., allocated $24 million to a separately managed, non-domestic equities account with Bankers Trust — Investment Management Group, New York, said Glenn Andrews, assistant vice president-finance.

In addition, Burroughs Wellcome moved $28.5 million to the RESA commingled open-end real estate fund managed by The Phoenix, Hartford, Conn., the fund's first real estate investment.

The $200 million pension fund at Pittston Corp., Greenwich, Conn., made its first international allocation, hiring Oechsle International Advisors, Boston, to manage an undisclosed amount, according to a company spokesman.

Funding for the manager will come from cash. SEI Funds Evaluation Services, Wayne, Pa., served as consultant.

Meanwhile, Schering-Plough Corp., Madison, N.J., hired Scudder, Stevens & Clark, New York, to manage $20 million as the $367 million fund's first active international equity manager, according to Candice Cox, director-trust investments.

Schering-Plough has invested in an international index fund managed by Chase Investors Management Corp., New York, for five years. The latest hire brings international investment to 11% of the fund's total assets.

Assets came from cash and reducing existing accounts, primarily equities. The search was conducted internally.

• WASHINGTON — The $1.1 billion District of Columbia Retirement Board has hired two minority-owned investment management firms to run $10 million each, according to Adrian Anderson, acting executive director for the fund.

NCM Capital Management Group Inc., Durham, N.C., will manage a fixed-income account, while Greaves/INVESCO, Atlanta, will run an equity portfolio. Both have been hired as part of an effort to establish a farm team of minority firms, and each could be given more funds to manage in the future, Mr. Anderson said.

• CHICAGO — The Quaker Oats Co. has hired three value managers to invest a portion of its $375 million pension fund.

Barrow, Hanley, Mewhinney & Strauss Inc., Dallas; Lehman Management Co., New York; and Miller, Anderson and Sherrerd, Bala Cynwyd, Pa., will manage equal amounts, according to Susanne Abosch, a financial analyst at Quaker. Ms. Abosch would not say how much each manager would receive.

The assets came from a manager termination made more than a year ago, she said.

Institutional Capital Corp., Chicago, and Sanford C. Bernstein & Co., New York, also manage equities for Quaker Oats.

DEPARTMENTS

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Norton Reamer

UAM owner aims high

By Carol Wiley

BOSTON — Norton Reamer isn't going to rest until United Asset Management Inc. owns at least 5% — better yet, 10% — of the institutional money management industry.

Considering the $25.5 billion United Asset Management has under management is only about 1%, he's just scratched the surface of an industry he estimates at $3 trillion.

"There's so much more to be done," he said. "We don't yet have any real estate firms or international firms. We could have several. We don't even have a firm in the city of New York. There are so many

Continued on page 33

Execs leave old posts for new ventures

4 choose different avenues

Several executives of large corporate pension funds recently have announced job changes.

• William H.S. Preece Jr. has resigned as director-corporate finance at Kraft Inc., Glenview, Ill., effective the end of this month. His plans are undecided.

• Judith W. Mares, who for most of the 1980s oversaw the pension investments at General Mills Inc., Minneapolis, and more recently was its assistant treasurer-international finance, has left the food products concern to become managing director of the investment group of Norwest Capital Resources, the institutional trust division of Norwest Bank, Minneapolis.

• Jack Miller has left his position as director of investments at Eli Lilly & Co., Indianapolis, to direct the investment of the pension plans of Philip Morris Cos. Inc., New York, and its subsidiary, General Foods, White Plains, N.Y. Although the assets probably will not be merged, they will for the first time be overseen at the parent company level by one person.

• R. Barry Thomas, assistant treasurer of Union Pacific Corp., New York, will become a consultant with Rogers, Casey & Barksdale Inc., Stamford, Conn., effective April 11.

Mr. Preece said he wants to return to specialization in pension investing, either with a plan sponsor or money management firm, and suspects he will wind up at the latter.

At Kraft, he had become more of a generalist in corporate financial matters, although he continued to oversee the company's $1.7 billion in employee benefit assets, he said. His successor has not been named yet.

With the company since 1981, one of the highlights of his tenure was the split of Dart & Kraft Inc. into Kraft and Premark International Inc. in 1986. "We put a very big fund together and pulled part of it apart," he said.

Ms. Mares is filling a new position at Norwest, according to Stan K. Medina, vice president and executive director. She will report to him.

She will oversee $2 billion of discretionary institutional investments and manage 12 professionals, composed of eight portfolio managers and four product managers, he said.

General Mills hasn't decided whether to replace Ms. Mares, ac-

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William H.S. Preece Jr. is leaving Kraft Inc. at the end of the month.

Active equities sizzle

$537.5 million in new business reported

By Trudy Ring

Active equity management outdrew indexing in the first quarter of 1988, while real estate and international bonds were popular alternative investments.

Of manager hirings reported in *Pensions & Investment Age* during the quarter, active equity management attracted $537.5 million. For domestic-stock indexing, only one $45 million account and two accounts of undisclosed size were reported.

These and other figures are based solely on reports published in *P&I Age* during the quarter; there might have been other were not publicized.

Real estate equity drew $329.4 million, while a hybrid venture capital-leveraged buy-out fund that will focus on real estate products attracted $185 million.

In international and global investing, bonds attracted $150 million, plus two accounts described as less than $100 million each. A total of $46 million went to actively managed international equities and $58 million to international stock-index funds. There also was $52.5 million channeled to international/global balanced management.

Annuities accounted for $180 million, all in a move by Mellon Bank, Pittsburgh, to cover some of its pension liabilities. Mellon bought the annuities from Equitable Life Assurance Society of the United States, New York.

Other asset classes that reported drawing money in the quarter were venture capital,

Continued on page 33

Most new accounts* 1st quarter 1988

Firm	New accounts
Union Labor Life Insurance	6
HGM Associates	4
Avatar Associates	3
Equitable Real Estate	3
Metropolitan Life	3
JMB Institutional Realty	3
Worldinvest	3

* As reported in *Pensions & Investment Age*

Most new assets* 1st quarter 1988

Firm	$ mils.
HGM Associates	185
Equitable Life Assurance	180
TCW Asset Management	170
Fidelity Management Trust	90
J&W Seligman	80
JMB Institutional Realty	68
Boston Co.	60
Equitable Real Estate	55

* As reported in *Pensions & Investment Age*

PORTFOLIO MANAGEMENT

Model signals shift in style

By Barry B. Burr

Energen Corp. and Puritan Bennett Corp. plan to boost the equity exposure of their pension funds in June, tilting toward a growth style.

The signal for the change comes in part from a tactical equity tilting model that is based on the relative performance of investment managers grouped by style.

Sponsors and consultants typically use style performances as benchmark measures to evaluate the results of their own managers with their peers. But Energen and Puritan Bennett, led by their consultant, Spectrum Advisory Corp., Chicago, go beyond that. They use the data to make equity allocation decisions.

Spectrum developed the two-step model, which determines a fund's equity exposure and how that exposure should be tilted between two equity styles, value and growth.

Because the two steps in the model are independent of each other, Spectrum could make shifts between equity styles without changing the overall equity exposure, or vice versa, although changes also could be made in tandem. Depending on the signals, the model might recommend shifts every quarter.

For the equity style tilting, Spectrum tracks the relative performance of 1,500 equity managers, broadly grouping them into either style. The more one style outperforms the other, the more assets the Spectrum model recommends be shifted to the style out of favor.

Robert Moseson, president and chief executive officer of Spectrum and its sibling company Performance Analytics Inc., claims both tactical shifts — the equity exposure and the equity style mix — add a total of 700 to 800 basis points a year over a static allocation.

Last year, for example, its clients' total returns for their pension funds averaged 10.3% (ranging from 9.4% to 14.3%). By comparison, 3.7% was the median return of several hundred other pension fund clients Performance Analytics tracks. These clients do not use the Spectrum allocation model. In contrast, the median pension fund in SEI Corp.'s universe returned 3.9% last year.

He attributed 200 basis points of the total added to the style tilt and the remainder to the equity exposure.

"You have to have good growth and value managers," he said. "Once you do that, the rest of the process is easy."

Performance Analytics provides performance comparison services. Spectrum makes the equity shift recommendations but does not manage money, although it is a registered investment adviser, Mr. Moseson said.

According Mr. Moseson, the allocation is based on the expectation that each equity style typically moves through cycles of under- and overperformance relative to each other. The Spectrum model attempts to capture most of the superior performance, while reducing the commitment before the style underperforms.

The style performances tell only where to place the equity bets; not how much money to place in equities overall.

For the overall equity exposure signal, Spectrum uses the market price-to-book value of the Standard & Poor's 400 stock index, in conjunction with the trends in performance by style.

Mr. Moseson said Spectrum advises the tactical shifts for 12 pension funds and one profit-sharing fund, ranging in size from $20 million to $700 million. In all, he said the clients have some $2 billion in assets following the allocation strategy. He disclosed the names of only two clients, the $60 million pension fund of Energen, Birmingham, Ala., and the $30 million pension fund of Puritan Bennett, Overland Park, Kan.

"Overall, we were happy" with the performance last year, said Walter E. McMahon, Energen's director-treasury operations.

"We have not gone back to see how we would have fared without Performance Analytics. But we certainly have done better than we would have under our old method."

At Puritan Bennett, Lee Robbins, chief financial officer, added, "At this point we're very pleased with their performance."

Until Energen hired Spectrum and Performance Analytics in December 1986, Mr. McMahon said the fund was kept for years in a static mix of bonds, equities and cash, all run by Equity Capital Management Corp., a unit of Equitable Life Assurance Society of the United States, New York.

In December 1986, Energen stripped Equitable of its equity assignment and hired Newbold's Asset Management, Philadelphia, and Stein Roe & Farnham Inc., Chicago.

Initially, Energen, following the advice of Spectrum, allocated

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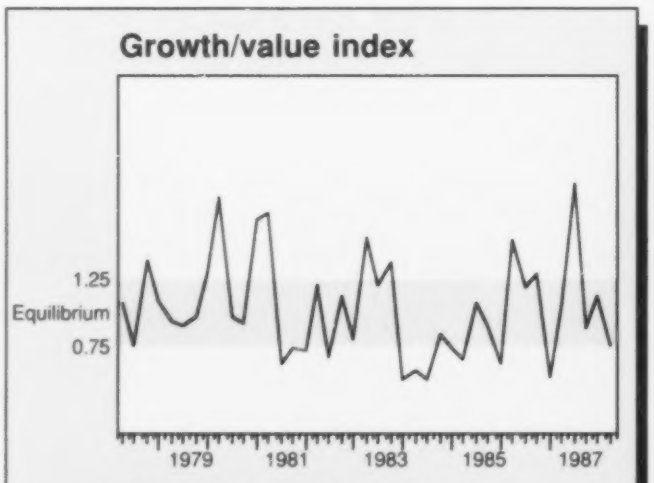

Source: Spectrum Advisory Corp.

FEATURE

1987 earnings weak

David L. White is executive vice president of Invista Capital Management Inc., Des Moines, Iowa

By David L. White

An issue that has been troubling me recently is corporate earnings. Specifically, they look too low.

The Standard & Poor's 400 stock index earnings for 1987 came in a little more than $20 per share after languishing around $16 for almost a decade. I think normal earnings for 1987 should have been closer to $30 per share. If I'm right, this has very important implications for the stock market and sectors within the market, given the importance of earnings in determining absolute and relative values.

Let's look at the history of corporate earnings from one business cycle peak to the next. Table 1 lists earnings for the S&P 400 starting with the 1957 economic peak and also lists the compound annual rate of growth in earnings adjusted for inflation from the previous cyclical peak. Excluding the unusual 1957 to 1960 cycle, the average rate of real growth in earnings was 3.8%. This compares with a −2.2% real growth rate in the most recent cycle from 1979 to 1987. In other words, unlike recent experience, it is customary to make progress in real corporate earnings from one cycle to the next.

Assuming normal real growth of 3.8% per year during the 1979 to 1987 period, earnings in 1987, after adding back inflation, would have been $32.80, not $20.40. Even if real growth had been only 2.4%, which was the lowest real growth of the four cycles, 1987 earnings would have been $29.40, again well above the actual $20.40 earned last year.

Problems with cyclical companies' earnings became evident as the economy began recovering from the last recession in late 1982. The high dollar short-circuited the normal economic recovery by causing imports to increase and exports to grow at a below-normal rate. Peak earnings for many cyclical companies still date to 1979 or 1978, despite 1987 being the sixth year of the economic recovery.

Unfortunately, many analysts only focus on the past five years, so they conclude earnings potential for many cyclical companies is hopeless.

Our economic system, however, rarely penalizes large and important parts of the economy forever. After all, Americans continue to consume increasing amounts of real goods, which ultimately puts demands on capital goods and basic industries. Now that the dollar is quite low, it does appear the fortunes of these industries are changing.

To grasp the potential of this important segment of our economy, it is necessary to go back before the sharp rise in the dollar, in other words, before 1982.

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TABLE 1

Year of economic peak	S&P 400 earnings	Peak to peak annual growth of real earnings
1957	$3.53	4.9%*
1960	3.40	−3.2
1969	6.13	3.5
1973	8.89	4.5
1979	16.29	2.4
1987	20.40	−2.2

* Compared to 1953

TABLE 2

	Return on equity 1965-'81*	Return on equity 1987	Normal p/e
Cyclicals			
Machinery	16.1%	4.6%	8.1
Industry	16.3	9.3	9.5
High Tech	19.5	3.4	7.4
Non-cyclicals			
Major growth	21.5	24.6	17.6

* Average

TABLE 3

	Earnings Actual	Earnings Peak	Peak/actual
1975	$ 8.58	$10.92	1.27
1979	16.29	17.49	1.07
1982	13.20	19.52	1.48
1987	20.40	30.26	1.48

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'87 earnings

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Table 2 compares the return on equity for a sample of companies representative of the S&P 400 for the 1965-'81 period with 1987 and also with the companies' normal price-earnings ratio. Average return on equity for cyclical companies was considerably higher from 1965 to 1981 than it was in 1987. Return on equity must improve significantly just to get to average conditions experienced from 1965 to 1981. If the 17-year period is representative of normal conditions, it is legitimate to multiply that period's return on equity by current book value to arrive at normal earnings. Remember, these are normal earnings, not peak earnings.

Contrast the cyclical companies with the non-cyclical ones — drug, soft drink and consumer-goods companies. Their 1965-'81 average return on equity is less than it was in 1987, just the opposite of the cyclical companies. That means normal earnings for these non-cyclical companies are less than current earnings, therefore, their normal p/e ratio is quite high. For most consumer-goods companies, current return on equity exceeds historical return. This makes sense because they have had an exceedingly favorable environment the past five years. It is difficult to imagine the next five years treating them as kindly. Not so for basic industry, machinery and equipment, and high-technology companies.

Another method of determining if reported earnings are normal is to compare the past peak earnings per share for the S&P 400 on an individual basis rather than for the index as a whole, as done in Table 3.

The past peak is constructed by taking the peak earnings of each company and weighting them according to the S&P 400. The past peak rises in each of the four years as the companies report new earnings highs as the economy advances.

When the economy is at its peak, actual earnings for each of the four years and past peak earnings should be about the same. When the economy is doing poorly, the difference should be wide.

For 1975, a recession year, the spread between actual and peak was wide: actual earnings needed to go up 27% to equal peak levels. In 1979 the economy peaked, so actual and peak earnings were almost identical. By 1982, the bottom of the last recession, actual earnings needed to go up 48% to match peak earnings. Although peak and actual earnings have risen nicely from 1982 to 1987, the gap between them remains as wide as it was in 1982.

Peak and actual earnings have continued to rise because the consumer sector of the economy has done quite well. The capital-goods oriented companies by contrast have done quite poorly; therefore, the gap between peak and current earnings has not closed.

What implications can be drawn from this analysis?

Current earnings are too low by a substantial margin. The 1987 earnings for the S&P 400 were about $10 too short of what they should have been under normal conditions. Because the normal level of earnings is about $30 not $20, the S&P 400's multiple is 11 not 16. Value judgments using a p/e ratio of 16 are incorrect.

Earnings for many consumer companies are too high and will surprise most investors by staying near current levels for several years. Earnings of the capital-goods companies will expand very rapidly.

Return to normal profits might not occur before the economy slips into a recession. However, I do think normal earnings will be achieved within the next five years. When reported and normal earnings converge, the stocks of capital-goods companies, broadly defined, and small companies will provide above average appreciation. ■

A special report on the best-managed companies in the U.S. will be published in the May 2 issue of *Pensions & Investment Age*.

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